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Energy infrastructure: Seizing the opportunity in growth markets

In some of the most promising markets, supply of and demand for reliable energy has outpaced infrastructure. For discerning investors, the opportunity to fund energy infrastructure is significant.

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More than 35 million Kenyans, 80 million Nigerians, millions of Ghanaians, and countless others in growth markets live without electricity. Some experts call this “light poverty.” But it is misleading to suggest that this unwired population—many of whom live in urban areas—cannot afford to pay for power or that governments cannot provide it. For many, a steady supply of electricity and gas would lower their cost of living by replacing inefficient, costly sources of energy such as kerosene and batteries.

The growth economies of Africa, South Asia, and Latin America are grappling with an energy-infrastructure investment gap. Existing power grids are limited, weak, and subject to

outages; generation is insufficient. In sub-Saharan Africa, nearly 70 percent of the population lacks access to electricity, and those with access find it unreliable. According to the African Development Bank, the region needs to invest approximately \$42 billion per year in energy infrastructure over the next decade. A similar gap exists in South America; in Peru, it is estimated at close to \$33 billion.¹

Investment can influence growth. For example, if Africa had invested an additional 3 to 5 percent of GDP in energy infrastructure, experts calculate that it could have gained \$0.7 trillion to \$0.9 trillion in incremental GDP from 2000 to 2010. Still, I believe that investing in new energy

infrastructure is not about stimulating economic growth in these countries—rather, it’s about sustaining it. Growth markets are outstripping developed economies with respect to GDP growth. A majority of the global middle class² lives in growth markets, and that proportion is expected to increase significantly in coming years. Demand for reliable, affordable electricity from homes and businesses will only rise. The capital needed to close this infrastructure gap represents a unique investment opportunity.

The demand side of the energy story is well documented. However, many growth economies are not merely customers for oil and gas; they also have extensive natural resources of their own. Nearly one-fifth of the world’s oil reserves are in Latin America. Africa holds almost 8 percent of oil reserves, in addition to shale oil and gas deposits. By 2030, 71 percent of global fuel supply is expected to come from markets that are not part of the Organisation for Economic Co-operation and Development (OECD). Energy transportation and storage infrastructure will be critical to extraction and distribution to the end consumer.

The reality is that in many of these markets, energy infrastructure must be built, as few existing assets are operational. Many global investors are hesitant to commit their capital to greenfield infrastructure, where development and construction risk is greater, particularly in non-OECD markets. Such thinking views growth economies as a monolith and overlooks the attractive rates of return such investments deliver. Rather than placing a blanket risk premium on all growth markets, I would encourage investors to take a closer look and recognize those countries that have transformed their investment environment in recent years. We have identified a number of key

growth markets that have created an outstanding investment environment for energy-infrastructure projects by combining viable project pipelines with a regulatory environment that mitigates risk.

Kenya is one such example. The country has an exemplary history of commissioning independent power plants from private investors and paying the agreed-upon tariff through its supply company, Kenya Power, while minimizing off-take risk and providing a strong, bankable credit. Kenya also intends to bring 5,000 megawatts—including 1,600 megawatts of geothermal energy—online in the next 40 months. Investors in geothermal projects can opt to invest after the initial exploration phase or take advantage of new insurance products coming onto the market.

Nigeria, another dynamic economy, will face a 13-fold capacity shortfall by 2020. The country needs massive investment to provide new capacity and replace existing diesel plants. The rising cost of diesel generation, combined with attractive feed-in tariffs for renewables, has created a major opportunity for solar-energy projects that generate a good rate of return and undercut existing power sources. A program to privatize ownership of ten newly built gas power plants has attracted interest from more than 100 investors around the world. Nigeria, like Kenya, waives duty on power-generation equipment. With the right approach, investments in Kenya, Nigeria, and other select jurisdictions can deliver excellent risk-adjusted returns.

Investing in energy-infrastructure projects is not without complexity. On the contrary, investors need to draw on technical expertise to ensure that projects are sound. As investors we demand bankability, but how we get there differs from

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place to place. Adapting to each growth market's unique conditions requires flexibility in the capital structure and security provisions for each project. And to be successful, investors need a deep understanding of how the project will be built, how it will behave over its lifetime (including the various risks at each stage), how to control life-cycle costs, and how to deal with the unique risks and challenges of each host country. These complexities and nuances can be addressed. Experienced developers with a deep understanding of the rules, regulations, and customs of the local market are well positioned to deliver successful projects in conjunction with their financial partners. However, financial partners need to expand their role, moving beyond providing capital to bring deep operational, technical, and geographical expertise.

In 2009, The Abraaj Group assumed operational control of Karachi Electric Supply Company (now known as K-Electric), a vertically integrated power utility in Pakistan. While there was latent and rising power demand in the area, underinvestment had left the company stagnant. We put together a comprehensive turnaround

plan, and over the next four years, the company curbed losses in transmission and distribution, decommissioned old power plants, and built new ones. As a result, it has generated positive earnings before interest, taxes, depreciation, and amortization since 2011 and reported positive net income in 2012 and 2013—after 17 years of losses.

The energy-infrastructure challenge is a unique investment opportunity that will pass when the infrastructure in growth markets catches up with that in developed regions. Although investor appetite is growing, competition among investors still lags behind more mature markets. Investors with deep local knowledge and in-house technical and operational expertise who partner with experienced developers will find quality investments that meet—and exceed—their needs. ○

¹ *The Report: Peru 2014*, Oxford Business Group, 2014, oxfordbusinessgroup.com.

² For the purposes of this article, the global middle class is defined as households with daily expenditures between \$10 and \$100 per person in purchasing-power-parity terms.